

CEPS SPECIAL REPORT

*Thinking ahead for Europe*

Nord Stream 2: A Legal and Policy Analysis

Alan Riley

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Abstract

This paper argues that the EU's energy regulatory regime applies to Nord Stream 2. It is indisputable that Union law applies in its own internal waters and territorial seas that Nord Stream 2 will pass through, and highly probable that Union law applies in the exclusive economic zone (EEZ) through which Nord Stream 2 will also pass. It goes on to argue that Nord Stream 2 is a transmission pipeline under EU law to which the full weight of the EU's liberalisation measures apply, including ownership unbundling, third party access and tariff regulation obligations. It argues that not only will Nord Stream 2 find it difficult to comply with the liberalisation obligations, but also that it will not be able to obtain Article 11 security of supply certification required under the Gas Directive. The paper also examines the options for applying an intergovernmental agreement solution to reconcile Nord Stream 2 with EU law. It argues that while the legal problems arising from an agreement between the Russian Federation and one or more EU states make such an agreement improbable, the political problems in obtaining a mandate to negotiate an agreement from the Council at EU level also make an EU-Russia agreement unlikely. It goes on to argue that Nord Stream 2 cuts across the Union's energy security principles enshrined in Council and Commission documents on Energy Union. Finally, the paper argues that Russia and the EU should move beyond diversionary pipeline disputes to making the most out of developing a gas single market from which both can benefit.



Alan Riley is a Senior Fellow at the Institute for Statecraft, Temple Place, London. This contribution is published as a companion piece to the CEPS Commentary by Ulrich Lissek entitled "Regulation of Nord Stream 2: Rule of Law, equal treatment and due process – A view from the project developer", 15 November 2016.

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CONTENTS

1. Introduction.....	1
2. Jurisdictional issues arising from the Nord Stream 2 pipeline: Application of UNCLOS and EU law in the Baltic Sea.....	3
2.1 The application of EU law within the territorial sea.....	3
2.2 The application of EU law within the Exclusive Economic Zone	4
2.3 Equal treatment and pipeline precedent	5
3. Impact of the designation of the pipeline as ‘transmission’, ‘upstream’ or ‘import’	8
4. Substantive consequences: Ownership unbundling – Third-party access and tariff regulation.....	9
4.1 Ownership unbundling.....	10
4.2 Third party access	11
4.3 Tariff regulation	11
5. The impact of an Article 11 (the third country, or ‘Lex Gazprom’ clause) analysis on Nord Stream 2	11
6. The scope for applying Article 36 to Nord Stream 2	13
7. Resolving Russian concerns? The international governmental option.....	16
8. The EUGAL pipeline	17
9. The Energy Community and Nord Stream 2.....	18
10. Nord Stream 2 and compatibility with EU policy	20
11. Conclusion: Nord Stream 2 – A way forward for Russia-EU energy relations?.....	24

Nord Stream 2: A Legal and Policy Analysis

Alan Riley*

CEPS Special Report No. 151 / November 2016

1. Introduction

This paper aims to provide a legal and policy analysis of the proposed Nord Stream 2 (hereafter Nord Stream 2 or NS2) pipeline project. Since the announcement of the Nord Stream 2 project in June 2015 at the St Petersburg International Economic Forum,¹ it has been mired in controversy. Concern has been expressed by a number of EU governments as to the impact on their supply security, the project's compatibility with EU law and the principles of the Energy Union.² It has been the subject of debate both in the European Parliament³ and in a European Council summit.⁴ Most recently the Polish competition authority issued objections against the Nord Stream 2 joint venture vehicle, based on concerns over the anti-competitive effect of the project within the Polish market.⁵ As a result, the Western corporate partners of Gazprom will exit from their shareholdings in the venture.⁶ At the time of writing this paper the author understands that Gazprom intends to undertake the financing of the entire project itself.⁷

Nord Stream 2 will follow a similar route and have the same capacity as the Nord Stream 1 pipeline project. It will run some 1,200 kilometres from the Russian Baltic coast, through the Gulf of Finland and through the Baltic Sea close to the Swedish island of Gotland before it lands near the German port of Greifswald. It will have a total pipeline capacity of 55bcm. The project involves running two pipelines with 27.5bcm capacity each. The project envisages that both pipelines will be constructed together with a commissioning date set for the end of 2019.

* Alan Riley is a Senior Fellow at the Institute for Statecraft, Temple Place, London.

¹ "Gazprom, E.ON, Shell and OMV agree upon developing gas transmission capacities to deliver Russian gas to Europe", Gazprom Press Release, 18 June 2015.

² "EU Leaders Sign Letter Objecting to Nord Stream 2 Gas Link", Reuters, 16 March 2016.

³ Notably in respect of a hearing on Nord Stream 2 which took place on 6 April 2016 at which the author gave evidence. See Hearing Nord Stream II-Energy Union at the Crossroads, European Parliament, Brussels, 6 April 2016.

⁴ The reference in the Conclusions of the Council, however, was somewhat oblique. It said: "The European Council calls for.... swift implementation of projects of common interest and optimal use of infrastructure for the benefit of a fully-functioning and interconnected market and energy security. Any new infrastructure should entirely comply with the Third Energy Package and other applicable EU legislation as well as with the objectives of the Energy Union." Para 19 (d), Conclusions of the Meeting of the European Council, 17-18 December 2015, EUCO 28/15.

⁵ Nord Stream 2: Application Withdrawn, UOKIK statement, 12 August 2016 (https://uokik.gov.pl/news.php?news_id=12511).

⁶ See "Gazprom Soldiers on with Nord Stream 2", *Natural Gas Europe*, 17 August 2016.

⁷ However, it is possible that the former corporate partners may well support funding mechanisms to ensure that finance is provided to the project. See "Nord Stream 2 partners 'eye' funding options", 29 August 2016 (upstreamonline.com)

Nord Stream 2 is registered as a Swiss company. Originally Gazprom had a 50% share with each of its five Western corporate partners – Shell, Wintershall, Engie, E.ON and OMV – holding each a 10% share. The project is said to cost €8 billion. Thirty per cent of the finance was to be raised by shareholders and the rest by external financing.⁸ As explained above, however, following the recent Polish competition authority ruling, these companies now plan to relinquish their shareholding in Nord Stream 2. Gazprom will now be the sole shareholder of NS2.

The argument of this paper is that notwithstanding the fact that the EU's energy regulatory regime was not applied to Nord Stream 1 (hereafter Nord Stream 1 or NS1), EU law does apply to Nord Stream 2. The paper argues that it is indisputable that Union law applies in its own internal waters and territorial seas that Nord Stream 2 passes through, and probable that Union law applies in the exclusive economic zone (EEZ) through which NS2 also passes through. It goes on to argue that Nord Stream 2 is a transmission pipeline under EU law to which the full weight of the EU's liberalisation obligations apply, including ownership unbundling, third party access and tariff regulation obligations. It argues that not only will Nord Stream 2 find it difficult to comply with the liberalisation obligations but also it will not be able to obtain Article 11 security of supply certification required under the Gas Directive.⁹ The paper also examines the options for applying an intergovernmental agreement solution to reconcile Nord Stream 2 with EU law. It argues that while the legal problems surrounding an agreement between the Russian Federation and one or more EU states make such an agreement improbable, the political problems surrounding obtaining a mandate to negotiate an agreement from the Council at EU level also make an EU-Russia agreement unlikely.

The paper then goes on to examine the compatibility of the Nord Stream 2 project with the EU's Energy Union policy. It finds that NS2 entirely cuts across the principles of the Energy Union, as set out in the Commission's Communication on Energy Union.¹⁰ In even launching Nord Stream 2, the principles of consultation and co-operation in respect of major energy projects that could affect the security and interests of other states were ignored. Equally, while the Energy Union principles promote diversification of routes and suppliers, Nord Stream 2 *concentrates* routes and increases supply dependency on a single supplier. In broader policy terms, Nord Stream 2 will undermine the measures taken by the EU and the US to support Ukraine following the annexation of Crimea, and the occupation and invasion of parts of eastern Ukraine.

In conclusion the paper argues that the EU should focus future EU-Russian energy relations around building a consensus that access to a deep liquid internal European gas market is beneficial for all parties. The EU should be willing to take steps to guarantee an expansion in the size of the European natural gas market, and Russia should evidence a willingness to follow the EU's market rules in the EU's own market. The ultimate alternative should also be pointed out to Moscow: That is for the EU to move over time away from Russian natural gas,

⁸ Nord Stream 2: Project Background, Press Release from Nord Stream 2, February 2016 (<http://www.nord-stream2.com/our-project/pipeline/>).

⁹ Directive 2009/73/EC of the European Parliament and of the Council concerning common rules for the internal market in natural gas, OJ 2009 L211/94, 14 August 2009 (hereafter the gas Directive).

¹⁰ Energy Union Communication COM 2015 (80) Final, 25 February 2015.

and away from natural gas generally, as more alternatives come on stream, both in respect of the gas market and as renewables further develop.

This paper is divided into 11 parts. Part 2 deals with the jurisdictional issues surrounding Nord Stream 2, notably questions concerning the operation of the EEZ and the United Nations Convention on the Law of the Sea (UNCLOS);¹¹ part 3 examines the options under the Gas Directive for the classification of Nord Stream 2 as a transmission or upstream pipeline; part 4 considers the application of the substantive liberalisation obligations to the Nord Stream 2 pipeline; part 5 considers how the application of the Article 11 supply security would be made in respect of NS2; part 6 examines in some detail the scope for obtaining an exemption under Article 36 of the Gas Directive; part 7 considers whether an intergovernmental agreement could reconcile the application of NS2 with EU law; part 8 assesses the extent to which NS2's feeder pipeline EUGAL would face restrictions under the Gas Directive; part 9 considers the impact on Nord Stream 2 of the law of the Energy Community; part 10 examines the extent to which Nord Stream 2 undercuts EU policy, particularly in respect to the Energy Union. And part 11 offers a conclusion.

2. Jurisdictional issues arising from the Nord Stream 2 pipeline: Application of UNCLOS and EU law in the Baltic Sea

It is understood that the proposed Nord Stream 2 pipelines will run along more or less the same route as the Nord Stream 1 pipelines.¹² Hence, there will be two new pipelines each with a carrying capacity of 27.5 bcm running through Russian territorial waters, and the Russian exclusive economic zone, and thence through the Finnish and Swedish economic zones. The pipelines then proceed through both Danish and German EEZs as well as Danish and German territorial seas, and German internal waters to arrive at Greifswald on the German coast.

2.1 The application of EU law within the territorial sea

It has been argued by pro-Nord Stream commentators that EU law is not applicable to the Nord Stream 2 pipelines.¹³ It is difficult to see how such an argument can be credibly sustained. In addition to going through the EEZs of Finland, Sweden, Denmark and Germany, the pipelines go through approximately 88km of Danish and 31km of German territorial waters.¹⁴

¹¹ United Nations Convention on the Law of the Sea, 10 December 1982 (http://www.un.org/depts/los/convention_agreements/texts/unclos/UNCLOS-TOC.htm).

¹² <http://www.nord-stream2.com/our-project/nord-stream/>

¹³ This is usually expressed in an oblique way, for instance: "No, the third energy package... does not apply outside the internal market". See Andrew Rettman, "Nord Stream 2: Business Unusual", *EU Observer*, 7 June 2016.

¹⁴ Plus a further 50km of inland German waters. These statistics are based upon the route and direction of Nord Stream 1. See S. Vinogradov, "The Challenges of Nord Stream: Streamlining International Legal Frameworks and Regimes for Submarine Pipelines", *OGEJ* (Oil, Gas and Energy Law Journal), 20, Vol. 9, No. 3, 2011.

Articles 2 and 3 of UNCLOS make it clear that the sovereignty of a coastal state may extend beyond its land territory and internal waters to the territorial sea which can be up to 12 nautical miles. Both Denmark and Germany have extended their territorial sea to the 12 nautical mile limit. Within the territorial sea of Denmark and Germany, and within the internal waters of Germany,¹⁵ domestic law and EU law are fully applicable. At least within those waters Nord Stream 2 can be subject to EU energy law, including the provisions of the 2009 Gas Directive.¹⁶

2.2 The application of EU law within the Exclusive Economic Zone

One significant additional question is whether EU law can also be applied in respect of the exclusive economic zones through which the Nord Stream 2 pipeline also passes. It is clear that in respect of infrastructures established in the EEZ and in the continental shelf as a result of Articles 60(2) and 80 of UNCLOS, the coastal state can apply its domestic law to regulate their operation. This would include therefore EU law. Hence, for example in *Salemink*, EU freedom of movement of persons law had to be applied to the recruitment of staff to an oil rig on the continental shelf.¹⁷

It is less clear how pipelines running through the EEZ are to be treated. One can argue that they constitute installations and structures that are subject to the domestic law of the relevant law of coastal state. In that case EU law will also apply as they would to any other structure such as the oil rig in the *Salemink* case. The difficulty with this argument is that Article 79(4) of UNCLOS appears to distinguish between installations and structures to which domestic law can apply and pipelines and cables to which a more limited domestic legal regime applies.

Article 79(1) of UNCLOS provides a right of all states to lay pipelines and cables. However, it appears to provide only a limited rights for coastal states to supervise those cables beyond the territorial sea. In Article 79(2) it provides that the coastal state may protect its rights of exploration and exploitation of natural resources and reduce and control pollution from pipelines.

The Court of Justice of the European Union (CJEU), however, is likely to be sympathetic to the case for permitting the application of EU law to pipelines in the EEZ. Drawing from the *Habitats Directive* case,¹⁸ it is clear that for both the *Habitats Directive* and the *Gas Directive* to be fully effective they need to be applied beyond the territorial sea and into the EEZ.¹⁹ To fail to apply the *Gas Directive* in the EEZ undermines the uniform application of the EU's liberalisation programme for the gas market and opens up the potential for evasion of the programme by market participants.²⁰ Furthermore, in *Kramer* the CJEU took a purposive

¹⁵ Internal waters are considered part of the territorial domain of a member state to which both national and EU law apply.

¹⁶ *Gas Directive*, op. cit.

¹⁷ C-347/10, paragraph 36.

¹⁸ C-6/04 *Commission v. United Kingdom*, Judgment of 20 October 2005.

¹⁹ *Ibid.*, Opinion, paras 132-133 and para 117 of the judgment.

²⁰ The argument here is that if EU law, and in particular, the Third Energy Package and specifically the *Gas Directive* did not apply to the offshore, the territorial sea and exclusive economic zone, then the objectives of the Third Energy Package would be undermined. By applying EU law solely to the soil,

approach to the extension of the application of Union law in respect of its application within the EEZ of a member state.²¹

In addition, UNCLOS is engaging the sovereign rights of the member states by providing for the freedom of third states to lay pipelines. Those pipelines infringe on a range of state interests which go beyond the exploitation of the sea bed or pollution and are required to be addressed by the law of the coastal states. For instance, Article 79 does not deal with other legitimate national interests that could be engaged as a result of the pipelines being constructed, such as broader health and safety concerns, economic regulation or security. Second, the application of EU law, and specifically the Gas Directive would in no way frustrate the laying of the pipelines. The pipelines can be laid. However, the application of EU law would ensure that the coastal state's regulatory structure in the energy sector was applied.

The alternative view is that UNCLOS provides an exclusive international regime for the laying of pipelines in the EEZ.²² Article 79 prescribes an exclusive regime and EU law can only be applied to the extent that that Article provides for environmental and resource exploitation purposes.

Even if however, the view were taken that the UNCLOS regime for pipelines was exclusive, it would still leave EU law fully applicable, including the Gas Directive 2009 with the territorial seas of Germany and Denmark, and the inland waters of Germany.

2.3 Equal treatment and pipeline precedent

For the objectives of the Third Energy Package to be achieved, the Union requires its liberalisation rules to be applied uniformly. It will be impossible to achieve a functioning single market, if in parts of that market, access can be denied at will to key pipeline and terminal infrastructure. Furthermore, if certain locations, such as the offshore, are viewed as immune from the application of the third package, this immunity is likely to incentivise commercial entities to develop more offshore infrastructure in order to avoid the application of Union law. Such a development will further undermine the effectiveness of the single market in gas. It is argued therefore that equal treatment is a crucial factor in the respect of pipeline infrastructure. The rules must be applied uniformly. It is as a consequence not surprising that the Gas Directive requires that all new infrastructure must comply with a common standard, ownership unbundling, and that there are significant exemption restrictions contained in Article 36. It also follows that the Commission has begun to bring already constructed infrastructure, as in the case of Yamal, discussed below, into conformity with the modern liberalisation regime. The necessity of equal treatment for effective operation

the full liberalization would not be fully achievable as parts of the infrastructure would remain subject to control by powerful market players who would be able to control both pipelines and supply. In addition, non-application to the offshore would have the effect of creating distortive incentives to build additional infrastructure in the sea, further undermining market liberalisation.

²¹ Joined Cases 3/76 et al [1976] ECR 1279.

²² I.A. Siddiky, "The International Legal Instruments for Cross-Border Pipelines", in K. Talus (ed.), *Research Handbook on International Energy Law* (2014), Cheltenham: Edward Elgar, pp. 308, 310 et seq.

of the single market also reinforces the argument that EU law operates not just in the territorial sea²³ but also in the EEZ.

Turning to some of the pipeline precedents. What gives credibility to the argument that EU law does not apply to Nord Stream 2 is that EU law was not applied to Nord Stream 1. Neither the second energy liberalisation package, which was in force when Nord Stream 1 was proposed, nor the third energy liberalisation package, which came into force during the construction of Nord Stream 1, was ever applied to the pipelines. No attempt was made to require tariff regulation, or third party access, which is required by either the second or third package. Nor did Nord Stream apply for an exemption under EU rules. It is clear from two parliamentary questions that the European Commission was aware of the situation. These questions were raised after the pipeline project was proposed and during construction. In both cases, the Commission responded by saying that it was undertaking an assessment of what EU rules would apply to the pipeline.²⁴ The Commission did not publish any assessment nor did it take any steps to apply or enforce EU law in respect of NS1.

The non-application of EU law by the Commission, other EU institutions or the member states does not provide an immunity to Nord Stream 1 from EU law, nor does that non-application provide Nord Stream 2 itself with any precedent or immunity it can rely upon.

What makes the Commission's non-application of EU law to Nord Stream 1 of even greater concern is that the Commission itself took a very different position in respect of South Stream. In December 2013 in the European Parliament, the Director of the Internal Energy Market in DG Energy made it clear that the six member states (Bulgaria, Hungary, Greece, Slovenia, Croatia and Austria) who had signed international agreements to develop the South Stream pipeline²⁵ project with the Russian Federation were in breach of EU law and that the agreements would have to be renegotiated.²⁶ The South Stream route ran through the Bulgarian territorial sea and its exclusive economic zone. Nevertheless the Commission pressed on and brought infringement proceedings against Bulgaria as Sofia indicated that it was willing to continue with the pipeline project.²⁷ It is also significant to note the position the Commission took prior to the infringement proceedings in June 2014 in respect to the application of EU law to the project in a response to a Parliamentary Question that,

²³ As argued above, it is taken as indisputable that EU law applies in the territorial sea. However, as arguments have been deployed that EU law does not apply to offshore pipelines, and that necessarily means including the territorial sea, and in fact NS1 was not subject to EU law in respect of the Second or Third Energy Packages this issue is worth exploring as discussed above and below here.

²⁴ Parliamentary Question P-3855/2007 of 19 October 2007, and Parliamentary Question E-3792/2010, 29 July 2010. It was also raised by the Commission itself further to a discussion of the Yamal Pipeline in Parliamentary Question E-8629/2010 where the Commission said that it was also assessing the Nord Stream Pipeline (that is, Nord Stream 1) but as yet no conclusion has been drawn. It remains the case that no conclusion has been reached that has been published or acted upon.

²⁵ It should also be noted that the Serbia, not a member state, but a member of the Energy Community, also signed an intergovernmental agreement with the Russian Federation in respect of the development of South Stream. The Energy Secretariat also brought proceedings under the Energy Community Treaty procedures against Serbia for breach of its obligations under that Treaty.

²⁶ "South Stream Bilateral Deals in Breach of EU Law Commission Says", Euractiv, 4 December 2013.

²⁷ "Bulgaria to Build South Stream Despite Commission Warnings", Euractiv, 3 June 2014.

The amendments to the Bulgarian Energy Act were adopted by the Bulgarian Parliament in a first reading and as such they are not yet in force. The Commission services' preliminary view is that the proposed amendments incorrectly and unilaterally exclude off-shore pipelines – which are under EU jurisdiction for any part on EU territory – from key elements of the Third Package rules.²⁸

If one accepts as argued above that at the very least EU law applies in the territorial sea and probably the exclusive economic zone then the comparison that can also be made is not just with pipelines such as South Stream which run at least in part through the offshore, but other pipelines bringing natural gas from Russia. If EU law applies offshore, then onshore pipelines are legally identical to those placed in the sea.

In this context then what makes the Commission's non-application of EU law to Nord Stream 1 even more perplexing is its approach to the application of the Yamal pipeline. This is a pipeline running through Russian Federation, Belarusian and then Polish territory and on into Germany. The Commission objected to the initial Intergovernmental Agreement (IGA) proposed by Poland and the Russian Federation in February 2010. The Commission required that the IGA and the operator agreement were brought into conformity with EU law. This meant compliance with then extant EU energy law principally the second energy package, and an agreement that when Poland implemented the third energy package, full compliance with the third package as well. This included certification of the operator by the Polish regulator subject to Commission supervision.²⁹

It is difficult to see how one can distinguish South Stream and the Yamal Pipeline from NS1 or NS2. All four would or are bringing gas from the Russian Federation into the EU. South Stream would have been laid out partly on land and partly in the sea. Yamal was constructed on land. NS1 and NS2 were or are to be constructed in the Baltic Sea. However, as explained above the fact of being constructed in the sea makes no difference in legal terms certainly as in respect of where the pipeline runs through the territorial sea, and given the case law of the CJEU, potentially through the EEZ as well. Furthermore, Yamal was constructed before the third energy package came into force, the first gas through the pipeline reached Poland and Germany in 1997, and it reached full capacity in 2005.

Notwithstanding the fact that major EU energy liberalisation reform took place after the Yamal pipeline came into operation, the EU insisted on full compliance with the new rules. The Russian and Polish parties had to agree to bring Yamal into compliance with the third energy package when it came into force in Polish law.

By contrast the first string of NS1 only came into operation in September 2011,³⁰ several months after the key 2009 Gas Directive was required to be implemented into national law by all member states.³¹ Yet, no steps were taken to bring NS1 into conformity with EU law.

²⁸ Parliamentary Question E-004869/2014, 12 June 2014.

²⁹ The terms of the agreement are set out in a response to a Parliamentary Question, found at E-8629/2010, 7 December 2010.

³⁰ The second string came on stream in October 2012.

³¹ By 3 March 2011.

The situation with NS2 is in some respects even starker. The proposition from Nord Stream 2 would appear to be that EU law should not be applied to the project even though it would be constructed well after the third energy package had been enacted into national law. By contrast there was an agreement in respect of ensuring the full application of EU law to Yamal, even before the third energy package had yet come fully into force.

Pro-Nord Stream commentators have also tried to bring into the debate a series of Maghreb pipelines from Algeria and Libya over the last three decades to undermine the argument that EU law should apply to pipelines bringing gas into the Union. This argument is difficult to sustain. When most of these pipelines were planned and constructed the third energy package, and in most cases the second energy package did not exist. Given the concept of legitimate expectation and legal certainty in EU law, the EU authorities will focus first on ensuring full compliance with all new pipelines, and then those pipelines which raise strategic single market and competition issues (such as Yamal) and then only later look at bringing the other pipelines into conformity with the modern liberalisation regime.³²

3. Impact of the designation of the pipeline as ‘transmission’, ‘upstream’ or ‘import’

In EU energy law there are only two types of pipeline classification relevant to pipelines bringing natural gas into the Union such as the Nord Stream 2 pipeline that can be identified in the Gas Directive. These are ‘upstream’ and ‘transmission’ pipelines.³³ An upstream pipeline is only subject to a limited range of liberalisation requirements, most notably the requirement to maintain fair and open access to pipeline capacity.³⁴ A transmission pipeline by contrast is subject to the full liberalisation provisions of the Directive, including ownership unbundling, third party access and tariff regulation.

In respect of upstream pipelines, Article 2(2) defines such pipelines as:-

any pipeline or network of pipelines operated and/or constructed as part of an oil or gas production project, or used to convey natural gas from one or much such projects to a processing plant or terminal or final coastal landing terminal.

In respect of transmission pipelines, Article 2(3) defines transmission as meaning:-

The transport of natural gas through a network, which mainly contains high pressure pipelines other than an upstream pipeline network and other than the part of high pressure pipelines primarily used in the context of local distribution of natural gas, with a view to delivery to customers, but not including supply.³⁵

³² See A. Goldthau, “Assessing Nord Stream 2: Regulation, Geopolitics and Energy Security in the EU, Central & Eastern Europe and the UK”, Kings College, London, July 2016, p. 22.

³³ The Gas Directive also refers in Articles 2(18) and 38 to direct line pipelines. These however envisage a supplier constructing a pipeline direct to specific eligible customers.

³⁴ Gas Directive, Article 34, op. cit.

³⁵ It could be argued that Article 2(3) should read with Article 2(17) which defines an interconnector as connecting two transmission systems “which crosses or spans a border between Member States”. The argument here is that if one reads Article 2(3) with Article 2(17) one could take the view that Nord

It is therefore very difficult to see how Nord Stream 2 can constitute an upstream pipeline under the terms of the directive. That pipeline is not conceived as being part of a production project to bring the gas from the project to a final coastal landing place, which for NS2 is Greifswald on the German coast. Nord Stream 2 and its Russian feeder network is also not a closed system, i.e. there are a series of entry points between the gas fields and the main pipeline. This again further undermines the likelihood that NS2 could be deemed an upstream pipeline connecting a production facility with a coastal landing place. In reality NS2 links up the Russian Unified Gas System (UGSS) with the German gas pipeline network, which is why it almost certainly will be deemed a transmission pipeline.

A further problem in making a determination that NS2 constituted an upstream pipeline is that in that the Commission has taken a different view of both the Yamal pipeline, as explained above, and the South Stream pipeline.³⁶ In both cases the Commission took the view that the full weight of the EU's gas liberalisation obligations were to be applied to both pipelines. In order to do so the Commission had to determine that both pipelines constituted transmission and not upstream pipelines.

Nord Stream representatives in debate with the author on 6 April 2016 in a hearing in the European Parliament,³⁷ and subsequently have argued that Nord Stream 2 constitutes an import pipeline³⁸ and that therefore EU law does not apply. This is again an argument that is difficult to sustain. Whilst NS2 clearly is an import pipeline, for the purposes of EU liberalisation law it can constitute only a transmission or upstream pipeline. There is no special additional category of 'import pipeline' upon which NS2 can rely.

4. Substantive consequences: Ownership unbundling - Third-party access and tariff regulation

This part now turns to analysing the legality of Nord Stream 2 in respect of the major substantive provisions of the Gas Directive in respect of ownership unbundling, third party access and tariff regulation.

Stream 1 and 2 are interconnectors not crossing a border between member states. However, as explained in detail in Part 6, the limitation to "between Member States" appears to be a drafting mistake. Recital 35 of the Directive expressly refers to the possibility of pipelines bringing resources from third countries being subject to the exemption regime of the Directive, which implies that otherwise the usual provisions of the Directive would apply. This view is also supported by the Commission's responses to a series of parliamentary questions in which the Commission assumed the NS1 could benefit from an exemption under the Directive.

³⁶ For a discussion of the Commission's investigation into the Intergovernmental Agreements entered into between several member states and the Russian Federation in respect of South Stream and specifically the extent of the Commission's concern in respect of the failure of the IGAs to comply with EU liberalisation law, see N. Dizdarevic, "Regulatory Aspects behind a Realisation of the South Stream", OGEL, Vol. 12, No. 2, 2014.

³⁷ Hearing on Nord Stream II-Energy Union at the Crossroads, European Parliament, Brussels, 6 April 2016.

³⁸ Goldthau, op. cit., p. 22.

4.1 Ownership unbundling

Article 9(1) of the Gas Directive requires that all new infrastructure can only be certified if the ownership of the pipeline is unbundled. The transmission system operator (TSO) has to own the network and cannot also be an undertaking involved in the production or supply of natural gas. Gazprom and its corporate partners initially planned to both own the pipeline, and they are all also active in the production and supply of natural gas. Currently it appears that Gazprom intends to continue with itself as the sole owner of the pipeline. As sole owner of the pipeline Gazprom would still be in the position that it was both owner of the pipeline via Nord Stream 2 and a producer and supplier of natural gas.

One way to potentially avoid the ownership unbundling obligation would be to argue that Nord Stream 2 was a mere extension of an existing transmission system which on 3 September 2009 was already part of a vertically integrated undertaking. The German National Regulatory Authority took this approach in its certification of the NEL pipeline which transmits gas from NS1. The NRA argued that as the Gascade network to which NEL would be connected was already approved as an independent transmission system operator (ITO), NEL could be deemed a mere extension to that network. Extending the ITO model to NEL would leave the network (though subject to important safeguards) in the hands of Gascade, which is a joint venture between Gazprom and BASF/Wintershall, all producers and suppliers of natural gas.

The Commission however, in its non-binding opinion was extremely sceptical of the approach of the German NRA. It pointed out that in September 2009 there was not even a final investment decision for the NEL pipeline.³⁹ Furthermore, the interpretative notes on ownership unbundling clearly distinguish between pipelines which exist before the 3rd September 2009 and those that follow after. The latter are required to comply with the obligations of full ownership unbundling.⁴⁰ The Commission also points that if NEL were a true extension then Gascade operator to whose pipelines NEL would be connected and who would own and run NEL, would not have required a new certification as a transmission system operator.⁴¹

The Commission has not yet launched infringement proceedings against Germany in respect of its decision on the NEL pipeline. However, it is difficult to see how Nord Stream 2 can easily run the same argument as was deployed by the German regulator in favour of NEL. In the first place, it would require deeming Nord Stream 2 an extension of Nord Stream 1. However,

³⁹ Commission Opinion, pursuant to Article 3(1) of Regulation (EC) No 715/2009 and Article 10 of Directive 2009/73/EC - Germany - Certification of the Operators of the Nordeuropäische Erdgas-Leitung (NEL), 18 October 2013.

⁴⁰ 'The ISO and ITO models can only be chosen for a specific TSO if on entry into force of the Directives, i.e. 3 September 2009, the transmission system belonged to a vertically integrated undertaking (Article 9(8) Electricity and Gas Directives). (...) New transmission systems, in particular systems which did not yet exist on 3 September 2009, will have to follow the ownership unbundling regime.' *Interpretative Note: The Unbundling Regime*, Commission Staff Working Document, 22nd January 2010, 5.

⁴¹ Whilst this opinion was not akin to a binding decision under Article 36, the NRA is supposed to take full account of the Commission's opinion. Ultimately, the Commission if it believes that a NRA is infringing Union law, can bring infringement proceedings before the EU Courts against the relevant member state.

Nord Stream 1 has never been certified as a TSO. Furthermore, it was not built, put into operation nor certified before the 3rd September 2009 deadline. The only other approach would be to deem NS1 and NS2 extensions of the German transmission system network. However, it would be legally ambitious to treat one never mind two set of pipelines each with a carrying capacity of 55bcm, and 110bcm in total as an extension of any existing network. The extension option is also relevant to Nord Stream 2's landside pipelines, notably EUGAL and is discussed further below.

4.2 Third party access

In Article 32(1) the Gas Directive provides that non-discriminatory access to pipelines should be granted to all shippers. This third party access requirement conflicts with the legislation of the Russian Federation which provides an export monopoly for Gazprom in respect of pipeline natural gas.⁴² The Russian Federation could lift the export monopoly legislation and permit other shippers to have access to Nord Stream 2's pipeline capacity. This is not an unreasonable requirement to be placed on the Russian Federation, after all the market for the natural gas carried by Nord Stream 2 is the European market and Nord Stream 2 in part runs across EU territory.⁴³ If it wishes to access the EU market then it should be willing to comply with EU law. However, given the resistance to any breach of the pipeline export monopoly from Gazprom this is likely to prove a stumbling block in seeking full Nord Stream 2 compliance with Union law.⁴⁴

4.3 Tariff regulation

Article 32(1) of the Gas Directive also envisages that tariffs charged for carrying natural gas will be regulated by the relevant NRA. Given that NS2 will cross more than one national boundary line the regulated tariff will have to be agreed between NRAs (at least the Danish and German NRAs).

5. The impact of an Article 11 (the third country, or 'Lex Gazprom' clause) analysis on Nord Stream 2

Article 11 of the Gas Directive requires an assessment to be undertaken of a transmission system operator which is controlled by a person from a third country as to whether granting certification will put at risk the security of energy supply of the relevant member state and the European Union. The assessment and certification is made by the NRA however, the

⁴² Federal Act of the Russian Federation No.117 FZ of 18 July 2006. This act was amended in 2013 the effect of which was to permit exports by non-Gazprom controlled businesses in respect of liquid natural gas exports.

⁴³ Furthermore, there are non-Gazprom suppliers available in Russia who would be delighted to ship natural gas into the European Union, including Novatek and Rosneft.

⁴⁴ In any lifting of the export monopoly there would also need to be agreement on how capacity would be allocated. The most likely approach here would be for an agreement between the relevant NRAs and the Russian authorities to apply EU law given that the sole destination for the natural gas is the European Union.

Commission must be informed and it will issue a non-binding opinion which the NRA must take into account in making its final decision.⁴⁵

The original structure of Nord Stream 2 gave Gazprom a 50% share of the operator which would be sufficient to bring NS2 within the scope of Article 11.⁴⁶ Given the withdrawal of the Western corporate partners of Gazprom from the Nord Stream structure it is probable that Gazprom will own all or most of the shares in NS2. Whether in respect of the original or probable corporate structure Nord Stream 2 would be considered to be controlled by a third country person.

The key question for the NRA's, most likely Germany, but at least also Denmark, as the pipeline passes through the territorial sea of both states, is the risk to 'security of energy supply of the member state' and the European Union.⁴⁷ This assessment will be difficult for the NRA's to make without coming to a conclusion that NS2 does pose a risk, if not to Germany or Denmark, then certainly to the EU as a whole, and in particular, the member states in Central and Eastern Europe. That is because currently CEE states have a degree of supply security in respect of natural gas flows via the Ukrainian pipeline and Yamal pipeline systems. Gas flows from Belarus and Ukraine and then onward into the CEE states before eventually reaching the large Western European gas markets. These flows provide the CEE states with a degree of 'throughput security'. Gazprom cannot cut off the CEE states for any significant period of time without also cutting off the states of Western Europe. It is difficult to argue that there is no realistic threat. Aside from the 2006 and 2009 gas cut offs, Larsson identified over 40 politically motivated cut offs in the CEE and Baltic States between 1991 and 2004.⁴⁸ One of the arguments that will be deployed by Warsaw, Budapest, Bratislava, Prague, Vilnius, Riga and Tallinn is that the effect of Nord Stream 2 is to undo the security gained from becoming member states and the subsequent decade long work to integrate the Baltic States and CEE gas markets. In other words certifying Nord Stream 2 threatens to plunge the CEE states back into a pre-2004 market of greater supply security risk and greater Russian leverage in their markets.

If Nord Stream 2 is constructed and certified most of the gas that would have arrived in the CEE states for onward transit to Western Europe will transit instead via Nord Stream 2. Russian natural gas flows to Western Europe can be maintained while CEE states are left isolated.

It could be argued that CEE supply security can be guaranteed by 'reverse flowing' from NS2 via the German pipeline system into the CEE states. There are however a number of concerns

⁴⁵ For a further discussion of the scope of Article 11, see Talus, *EU Energy Law and Policy: A Critical Account* (2013) OUP 3.3.2.

⁴⁶ The definition of control in the Gas Directive is taken from the EU merger regulation (see recital 10 of the Gas Directive. The definition of control in the EU Merger Regulation is very broad. It is unlikely that the Commission would come to any conclusion other than that Gazprom had 'decisive influence' they key test under the Merger Control Regulation. For a further discussion see Bellamy & Child, *European Union Law of Competition*, (2013) OUP, para 8.023 et seq.

⁴⁷ If the view is taken that EU law applies in the EEZ of Sweden and Finland, the Swedish and Finnish NRAs would also have to participate in any decision on the certification of NS2.

⁴⁸ Larsson, *Russia's Energy Policy: Security Dimensions and Russia's Reliability as an Energy Supplier* (2006) FOI (Swedish Defence Research Agency), Stockholm.

with this proposal. Even if German goodwill is guaranteed, the CEE states will face significant extra costs as a result of the transit fees necessary to bring gas via Nord Stream and the German pipeline network.⁴⁹ It is also far from clear that Germany can guarantee such flows. In 2014 Gazprom objected to CEE states reverse flowing gas (i.e. gas that they had bought and acquired title to) to Ukraine. In an attempt to stop such practices Gazprom reduced the amount of natural gas supplied to some CEE states.⁵⁰ A major concern for CEE states is that they could also be the target of such action against any reverse flows of natural gas from NS2 that were supposed to reach their markets.

Given these risks it is difficult to see how any NRA or group of NRAs can legitimately certify Nord Stream 2 for the purposes of Article 11. Furthermore, given the state interests that are engaged any certification would face a well- resourced legal challenge, ultimately ending up before the European Court of Justice.

6. The scope for applying Article 36 to Nord Stream 2

One approach to dealing with the burden of the obligations contained in the Gas Directive is for Nord Stream 2 to seek an Article 36 exemption. In order to encourage investment in new energy infrastructure the Directive provides for an exemption period (for example for a decade) from the application of the full rigour of its provisions. For that exemption period, the ownership unbundling, third party and tariff regulation rules would not apply.⁵¹

On a first reading of the directive it would appear that Nord Stream 2 would not be able to rely on Article 36. This is because when Article 36 (1) is read with Article 2(17) it would appear that interconnectors between an EU and non-EU member states cannot benefit from Article 36. Article 36(1) provides that,

Major new gas infrastructures, i.e. interconnectors, LNG and storage facilities, may, upon request, be exempted for a defined period of time.

Article 2(17) then unhelpfully defines an interconnector as meaning,

a transmission line which crosses or spans a border between member states for the sole purpose of connecting the national transmission systems of those member states.

As Nord Stream 2 connects pipeline networks between EU states and a non-EU state it would appear therefore at first sight that an exemption is not possible under Article 36. However, it is clear from Recital 35 of the Directive that the EU legislator did envisage third countries being able to benefit from the exemption. It reads:-

⁴⁹ Zachmann, “Nord Stream 2: A Bad Deal for Germany and Eastern Europe”, Breugel, Brussels, 18 July 2016.

⁵⁰ “Hungary Halts Flows of Gas to Ukraine”, *Financial Times*, 26 September 2014.

⁵¹ The texts of the Commission’s Article 36 exemption decisions can be found at this link here:- https://ec.europa.eu/energy/sites/ener/files/documents/exemption_decisions_15.pdf

The possibility of temporary derogations should apply, for security of supply reasons, in particular to new pipelines within the Community transporting gas from third countries into the Community.

The text of Recital 35 suggests that there was a drafting mistake at least in respect of Article 2(17) and possibly in Article 36(1). Given the purposive approach to interpretation taken by the CJEU and the evident intent of the Union legislature it is probable that an exemption is possible under Article 36.

This appears also to be the position of the Commission. In numerous responses to Parliamentary Questions concerned with Nord Stream and South Stream over the last decade, the Commission never raised the issue of the non-applicability of either project in respect of an Article 36 exemption. To the contrary, the Commission appeared to welcome the prospect of either project filing for an exemption.⁵²

Despite the Commission taking the view that Gazprom could file for an exemption request no such request has ever been forthcoming for Nord Stream 1, South Stream or the European part of Turkishstream. Part of Gazprom's reasoning is likely to have been influenced by the fact that for most of the last decade it has been promoting diversionary pipelines, rather than actually providing new gas supplies. As a consequence Gazprom and its corporate allies in Nord Stream 1 or 2, South Stream or Turkishstream would have great difficulty in complying with the conditions for an exemption under Article 36(1). This is because Article 36(1) (a) provides that for an exemption to be granted the project, 'must enhance competition in gas supply and enhance security of supply'. As diversionary pipeline projects such as Nord Stream 2 will only shift natural gas transited from the Ukrainian pipeline network to being transited via Nord Stream 2 there is no enhancement of competition in gas supply.

Furthermore, any attempt to justify diversifying pipeline routes due to the alleged lack of reliability of the Ukrainian pipeline network would be likely to be vigorously challenged. As pointed out above from the research work undertaken by Larsson, discussed above, the most significant disruption in gas supplies in Europe between 1991 and 2004 has emanated from Russian sources.⁵³ This view of Russian responsibility is reinforced by the 2014 attempts to reduce gas flows to EU member states supplying Ukraine with natural gas on a reverse flow basis.⁵⁴ Furthermore, in any exemption process, the Commission would also be able to point out that there have been no disruption in Ukrainian transit flows since 2009. Ukraine is now committed via its membership of the Energy Community since 2011 and also via its recent EU inspired energy liberalisation legislation to comply with the EU energy acquis. This Commission view is reflected in its response to a Parliamentary Question in February 2016 in which the Energy Commissioner Mr Canete said:

⁵² For example, response to Parliamentary Question E-001009/2014, 31st March 2014. "No exemption has been granted or requested for the Nord Stream pipeline project. Should South Stream promoters decide to apply for exemption under the 3rd Energy Package, the Commission stands ready to review the national regulators decision on such requests." See also response to Parliamentary Question E-010819/2013, 14 November 2013, in which the Commission specifically refers to Article 36(1) and goes on to indicate that no exemption request had yet been submitted by South Stream.

⁵³ Larsson, *op. cit.*

⁵⁴ Hungary, *op. cit.*

The Commission stands on the position that Ukraine continues to be a reliable transit partner for Russian gas and it is in the interests of all parties that Ukraine remains an important transit country.⁵⁵

As a consequence Gazprom and its corporate allies are likely to have taken the view that they did not want to put themselves in a position where they would come under intense regulatory scrutiny by seeking to justify a diversionary pipeline.

A further problem for NS2 is also found in condition Article 36(1) (e) which provides that:

The exemption must not be detrimental to competition or the effective functioning of the internal market in natural gas or the efficient functioning of the internal market in natural gas.

The difficulty here is that Nord Stream 2 is clearly detrimental to competition and the effective functioning of the internal market in natural gas. There are a series of concerns surrounding NS2 in respect of the impact it will have on competition on the European gas market. Firstly, NS2 by providing Gazprom, already a dominant market player in Germany, with yet more capacity it will increase Gazprom's market power both in Germany and across North-Western Europe. Secondly, there is a danger of the market in North-Western Europe becoming foreclosed with Gazprom sourced gas. NS2 would provide Gazprom the means to seal off the European market from the growing supply of LNG sourced gas resources.⁵⁶ This may well also in part explain the rush to get NS2 constructed before substantial flows of LNG reach Europe. Thirdly the impact of the additional capacity will deter investment in new LNG terminals and interconnectors that could bring alternative sources of supply into the European market.⁵⁷ Fourth, NS2 will increase Gazprom's market power in CEE markets, rendering local market players more vulnerable to Gazprom.⁵⁸ These concerns are likely to have influenced the Polish competition regulator UOKIK when it issued a statement of objections against Nord Stream 2. Fifth, NS2 on top of NS1, Yamal, the existing Ukrainian network and potentially Turkishstream will give Gazprom huge market pipeline optionality which is likely to affect gas flows and pricing across the Union's gas market. This pipeline optionality will permit Gazprom to significantly offset the impact of the steps to market liberalisation and integration that have been undertaken over the last decade.

From a pure single market perspective Nord Stream 2 also threatens to slow down the development of an integrated European gas market by deterring investment in infrastructure that will promote further integration. NS1 and NS2 will be able to provide so much additional resources into both North West Europe and Central and Eastern Europe that market incentives to construct additional infrastructure or provide additional supply will be undermined.

⁵⁵ Parliamentary Question E-00291/2016, 26 February 2016.

⁵⁶ *International Energy Outlook 2016*, EIA, Washington DC, 11 May 2016, 37 *et seq.*

⁵⁷ The European Commission has established a list of Projects of Common Interest (PCI) which focuses on projects which increase market integration and particularly increase route and supply diversity. See DG Energy's dedicated website page for further details of the current list of PCI's. <https://ec.europa.eu/energy/en/news/commission-unveils-list-195-key-energy-infrastructure-projects>

⁵⁸ For a further discussion see Zachmann, *Nord Stream 2: op cit.*

Taking these factors together, it is not surprising that Gazprom has shied away from seeking an exemption under Article 36(1) for any of its diversification pipeline projects. It is probable that if it were to do so any exemption request would be deemed to fail to fulfil the conditions for exemption. NS2 would also face a ‘hard’ decision from the Commission in that unlike Article 11, Article 36 only permits the NRA to receive the exemption request, with the ultimate decision resting with the Commission, not the NRA. Any exemption decision would be likely to face filings of interested parties and would be immediately susceptible to legal challenge by parties dissatisfied with any decision before the EU courts. This level of due process, transparency, together with the prospect of legal challenge is also likely to have had an impact on Gazprom’s view of the value of seeking an exemption.

7. Resolving Russian concerns? The international governmental option

One option potentially open to dealing with concerns in respect of the application of EU law to Nord Stream 2 would be to adopt an intergovernmental agreement as means of resolving any conflict.⁵⁹ This however is more difficult than it first appears. Member states cannot simply contract out of EU law via engaging in international agreements with third countries. In respect of both Yamal⁶⁰ and South Stream⁶¹ the Commission insisted on full compliance with the terms of the third energy package in the text of the IGAs. With Yamal, full TSO certification under the Gas Directive is underway,⁶² and in the case of South Stream the Commission was prepared to initiate infringement proceedings against member states who had agreed IGAs with the Russian Federation that infringed EU law.⁶³

The constitutional position of IGAs made by member states with third states, subject to the supremacy of Union law, and past practice makes it difficult to see how a IGA could be agreed between say German and Denmark plus Sweden and Finland (the latter two as EEZ states) where only the ‘principles’ of the third energy package would be complied with and not the substance of the legislative provisions. Any such IGA would be as the Yamal and South Stream precedents suggest be subject to infringement proceedings by the Commission. Furthermore, it is difficult to see how it would be possible to contract out in any way Article 11, where the member states and the Union are undertaking an exercise in public policy evaluation, which is exclusively a responsibility of the member states and the Union authorities.

Potentially the Union itself would be able to enter into negotiations for an IGA with the Russian Federation. However, the major barrier here is that given the controversy over Nord Stream 2 it is doubtful that the Council would be able to grant the Commission the mandate

⁵⁹ Already the Commission has limited supervisory powers in respect of energy IGAs contained in Council and European Parliament Decision, 994/2012/EU, OJ 2012 L299/3, 27 October 2012.

⁶⁰ Yamal IGA conformity with EU law, Parliamentary Question, found at E-8629/2010, op. cit.

⁶¹ Dizdarevic, South Stream, op. cit.

⁶² Yamal IGA conformity with EU law, Parliamentary Question, found at E-8629/2010, op. cit.

⁶³ Dizdarevic, South Stream, op. cit.

to negotiate an IGA.⁶⁴ In addition, there remains the difficulty of undertaking an Article 11 assessment under an IGA.

8. The EUGAL pipeline

With Nord Stream 1 additional landside pipelines were required to deliver NS1 gas from landfall at Greifswald into Germany and broader European markets. The landside pipelines are NEL and OPAL taking gas respectively westwards further into Germany and the Netherlands and south through eastern Germany and in the direction of the Czech border. Because of the provisions of the Gas Directive, particularly requirements in respect of third party access both pipelines have been subject to restrictions on how capacity be utilised by the owners of the pipelines. Currently that is restricted to 65% for NEL (with 20bcm capacity) and 50% for OPAL (35bcm capacity).⁶⁵ OPAL has recently requested greater access to the capacity of the pipeline via auction the remaining 50% capacity and that request is under consideration by the Commission.⁶⁶

There will be a similar debate between Gascade the putative owner and TSO of EUGAL, the German NRA, and the European Commission over the application of the Gas Directive to EUGAL.⁶⁷ One issue is whether EUGAL is going to be treated as an ‘extension’ of an existing pipeline network and thereby not be subject to full ownership unbundling? A further concern is whether an exemption can be granted under Article 36 at all for the EUGAL pipeline. Unlike OPAL or NEL, EUGAL is a conduit for almost all of the supply capacity of the new Nord Stream. As a consequence all of the concerns which apply to Nord Stream 2, in respect of its capacity to obtain an exemption apply similarly to EUGAL. It does not add to supply enhancement as it merely replaces supply that would have been provided via the Yamal or Ukrainian pipeline networks. It also does not add to competition. Instead it increases Gazprom’s market power in Germany and in CEE states. It forecloses markets and undermines the development of the single market.

There is also a further question in respect of the application of Article 11 of the Gas Directive. With the Polish part of the Yamal pipeline, even though Gazprom directly controlled less than 50% of the pipeline, the Commission asked the Polish regulator undertake a full Article 11 analysis of the pipeline. Given that the Gazprom holds half the shareholding in Gascade, and will provide the natural gas and provides its corporate energy partners with access to upstream assets it is likely that the EU courts would deem Gazprom to have decisive influence

⁶⁴ There is also the question as discussed below in part 9 as to how far any such IGA would be compatible with the obligations of the European Union under the Energy Community Treaty.

⁶⁵ For a discussion of the impact on NEL and OPAL of EU energy liberalisation law see Bros, “There will be Gas: Gazprom’s Transport Strategy in Europe”, (2015) IFRI, Paris, 29-30.

⁶⁶ “European Commission Delays Ruling on New Gazprom Bid for German Gas Link Opal Use”, Platts S&P Global, 14 July 2016.

⁶⁷ For a detailed discussion see Loskot-Stratchota, “EUGAL-The Unknown German Branch of Nord Stream 2 Will Make Germany the Key Gas Hub in Europe”, *Energy Post*, 6 July 2016.

over EUGAL. That being the case an Article 11 certification would be required and again as for Nord Stream 2 it is difficult to see how such a certification could be provided.⁶⁸

The negative market impact of EUGAL is reinforced by the fact it largely follows the route of the OPAL pipeline.⁶⁹ The land capacity is initially envisaged to be 51bcm, with 35bcm of OPAL that gives Gazprom potentially 86bcm of capacity it can deploy into Central and Eastern Europe.⁷⁰ If EUGAL is built it is unlikely that additional interconnectors will be built to further integrating the Union market in the CEE states. In addition, the expansion of new sources of supplies and access to new sources of supply is likely to be limited. For example, the proposed North-South gas corridor (which would more or less run in parallel with OPAL/EUGAL for at least the first part of its route) will be unlikely to be fully developed. The North-South corridor pipeline would have provided an alternative source of supply of LNG initially from the Polish LNG terminal south toward the Croatian/Hungarian border.⁷¹

9. The Energy Community and Nord Stream 2

An underlying but so far unarticulated point that flows through this paper is that the speed with which the Nord Stream 2 project was decided upon meant that many legal and policy issues were overlooked. It may well be that the promoters thought that as Nord Stream 1 was brought into operation without too much difficulty so could Nord Stream 2. However, as explained above, a lot has changed since Nord Stream 1 was conceived, promoted and executed. The third energy package, and in particular the Gas Directive came into force, and

⁶⁸ There is also a further question in respect of OPAL and Nel. Neither the NRA nor the Commission raised the question of Article 11 certification despite Gazprom's significant shareholdings in the TSO. Given the level of control Gazprom exercised over both TSOs, as with the Polish part of the Yamal pipeline, that control may constitute decisive influence for the purposes of the Gas Directive. For instance, significant long term supply agreements may confer decisive influence. The argument here would be that the substantial shareholding, plus Gazprom's supply of natural gas to the pipelines, and the lack of availability of any other alternative supply and the impact of the asset swaps in fostering dependence on the other corporate shareholders in OPAL and Nel. See Bellamy & Child, *op. cit.*, para 8.032.

⁶⁹ There are a group of parallel legal issues that are also of concern in relation to NEL and OPAL. The one discussed above in the main text is the willingness of the German regulator to treat NEL as an extension pipeline placing it outside the scope of the new infrastructure provisions of the Gas Directive. There are however other concerns. It is open to question how OPAL can have been granted an exemption under Article 36 when OPAL does not provide additional gas supplies but rather provides only gas on a diversionary basis (i.e. gas from Ukrainian transit route than any new actual supply coming into the Union). There are also competition law concerns with granting a dominant supplier of gas yet greater capacity to provide gas into EU markets and provide that supplier yet more control over the pipeline network. Furthermore, following on from the argument in the footnote above. No Article 11 certification analysis appears to have been carried out for OPAL or NEL despite the fact that Gazprom has significant shareholdings of the pipeline; it provides the gas and the corporate partners are dependent on Gazprom for access to upstream assets.

⁷⁰ The impact of the pipeline capacity of OPAL combined with EUGAL would also make it more difficult to obtain Article 11 certification for EUGAL given the compound disincentives to develop new interconnectors and dependencies that it creates in the CEE states.

⁷¹ "Completing Europe: From the North-South Corridor to Energy, Transportation & Telecommunications Union", Atlantic Council, Washington, D.C., November 2014.

case law and decisional practice precedent has been established. Furthermore, as explained below the policy context has also radically changed, both in terms of the focus on supply security and in respect of relations with Russia. These legal and policy factors make the delivery of NS2 much more challenging than delivering NS1.

A particularly overlooked factor is the role of the Energy Community. The Energy Community Treaty came into force in 2006. The European Union as well as the West Balkan states, Moldova and Ukraine are members. The Energy Community extends the application of the EU's energy acquis, plus flanking measures in competition and environmental law to the non-EU West Balkan states, Moldova and Ukraine.⁷²

When NS1 was being promoted and then constructed the Energy Community was in nascent form, and crucially Ukraine was not a member. It only became a member in 2011.

The difficulty now for NS2 is that it does not only have to navigate EU law, but also the Energy Community obligations of the EU. These are significant. As with the EU Treaties, there is a duty of loyalty and co-operation contained in Article 6 of the Energy Community Treaty.

The major difficulty for NS2 is that in any assessment of an application for an exemption under Article 36 or initially a Commission opinion in respect of Article 11, and subsequently a decision in respect of Article 11 by a NRA, the EU and national authorities must take account as a matter of loyalty and co-operation the impact on the Energy Community member states of any decision that they may make.

Given that Ukraine will be seriously affected by NS2 a number of problems will arise on any Energy Community analysis. Taking into account Energy Community considerations, it is difficult to see how any exemption under Article 36 would be possible for either NS2 or EUGAL.

Taking into account Energy Community considerations, it is difficult to see how any exemption under Article 36 would be possible for either NS2 or EUGAL. Neither NS2 nor EUGAL add to supply for Ukraine. They clearly would have the effect of removing supply from that country. Nor do they add to competition. Their effect is to increase Gazprom's leverage, isolating the market and making the delivery of reverse flows of natural gas more difficult. These difficulties would be in addition to those that flow solely from an EU law analysis discussed above.

There is a similar problem in respect of Article 11 taking into account an Energy Community perspective. From the perspective of the EU and the Energy Community's supply security as a whole, Ukraine's supply security would be undermined in the same way as the EU member states. It would lose throughput security, and would be subject to greater leverage by Gazprom. The same concern in respect of a reverse flow solution would apply to Ukraine, save that Ukraine actually has already experienced attempts by Gazprom to cut off reverse flows by targeting flows to EU states.

⁷² See Riley, "Deploying the Energy Incentive: Reinforcing EU Integration in South-East Europe" (2013) CEPS, Brussels, and Holland & Hasmuca, "Energy Community 2014: A Legal Commentary" (2015) Saarbrucker Verlag fur Rechtswissenschaften.

At a minimum the Union authorities and the member states have legal duties flowing from the Union's membership of the Energy Community which will make it more difficult to arrive at decisions in respect of an exemption decision or Article 11 certification that would be favourable to Nord Stream 2.

10. Nord Stream 2 and compatibility with EU policy

The difficulties of bringing Nord Stream 2 within the framework and substance of EU law are set out above. However, the difficulties do not end there. There are also great difficulties in reconciling the Nord Stream 2 project with the EU's energy and security policies. Most notably this is the case with what is supposed to be the current European Commission's leading policy project, the European Energy Union.

For example, the Commission in its 2015 Communication on Energy Union emphasised the need for 'solidarity and trust' between the member states in order to deliver secure energy to their citizens.

Our vision is of an energy union where member states see that they depend on each other to deliver secure energy to their citizens, based on true solidarity and trust, and of an energy union that speaks with one voice in global affairs.⁷³

The practical reality of the importance of solidarity and trust in respect of co-operation and consultation between the member states had already been outlined in the 2014 Energy Security Strategy Communication in which the Commission said,

A European internal market for energy is a key factor in energy security and is the delivery mechanism to achieve it in a cost-effective way. Government interventions that affect this market framework, such as national decisions on renewable energy or efficiency targets, decisions to support investment in (or decommissioning of) nuclear generation, or decisions to support key infrastructure projects (such as Nord Stream, South Stream, TAP or a Baltic LNG terminal) *need to be discussed at European and/or regional level to ensure that decisions in one member state do not undermine security of supply in another member state* (author's emphasis). Various tools exist at EU level to implement such projects in respect of the *acquis* and in a coordinated manner (internal market legislation, TEN-E Guidelines, State-Aid control). A real European Energy Security Strategy requires that enforcement tools are preceded by a strategic discussion at EU level, not just at national level.⁷⁴

However, despite the Commission highlighting the importance of consultation and co-operation in developing new projects in 2014, and emphasising the need for solidarity in February 2015, the Nord Stream 2 project was announced without consultation in June 2015. It was announced at the St Petersburg International Economic Forum with no prior discussion with the EU institutions or affected member states in Central and Eastern Europe or the Baltic States. Even after the announcement, the project, which clearly received high level German

⁷³ *Energy Union Communication*, op. cit., 2.

⁷⁴ *European Energy Security Strategy*, Communication from the Commission to the European Parliament and the Council, COM (2014) 330 Final, 28 May 2014, 8,

government support,⁷⁵ was rushed forward with a shareholders agreement been signed in Vladivostok in September 2015. Again with little or no consultation with the member states or EU institutions, their interests, security policies or the policies of the Union. Furthermore, if the Kremlin's report of the minutes of the meeting between German Vice-Chancellor Sigmar Gabriel and the Russian President are correct, the German approach was in fact to freeze out the application of Union law, Union policies and Union institutions from the development of the Nord Stream 2 project.⁷⁶ At the very least, there was a failure by the German government and the Western corporate partners of Nord Stream 2, to discuss the project with those states most affected by the project prior to proceeding with its development.

Failure to consult and co-operate in respect of Nord Stream 2 is not the only failure of the promoters of the project to adhere to the principles of the Energy Union. The Energy Union Communication also emphasises the need for diversification of energy sources, suppliers and routes in order to ensure secure and resilient energy supplies. The Communication emphasised the importance of opening up new routes, with new sources of supply such as the Southern Gas Corridor and the need in Northern Europe for liquid hubs with multiple sources of supply.⁷⁷

Nord Stream 2 by contrast involves a *concentration* of supply routes. Instead of relying on Nord Stream 1, Yamal and the Ukrainian pipeline network, Russian gas supplies would be entering the EU largely via one route, the Nord Stream pipelines. Equally, by providing Gazprom with yet more capacity, Nord Stream 2 would create more dependence on one gas supplier in Germany⁷⁸ and across North-West Europe. Simultaneously the development of Nord Stream 2 would undermine the investment incentives for the North-South Corridor and LNG terminals, reducing the likelihood of new routes and sources of supply being developed.

One can therefore credibly argue that Nord Stream 2 amounts to a reverse Energy Union policy. The project in direct contradiction to the principles of the Energy Union seeks to concentrate pipeline routes and increase supply dependence on a single supplier.

The project also clearly undermines one of the key means of enhancing the supply security of the member states: a single European gas market. A deep functioning gas market with multiple routes and sources of supply and a physically interconnected market in which EU energy liberalisation rules are uniformly applied will provide a significant degree of supply security for all states. Nord Stream 2 undermines this objective in its route concentration, increased supply dependence and the investment disincentives it generates for new interconnectors and terminals.

⁷⁵ Nord Stream 2 to Enhance Reliability of Russian Gas Supplies to Europe, 8 July 2015 (<http://www.gazprom.com/press/news/2015/july/article239944/>).

⁷⁶ "What's most important as far as legal issues are concerned is that we strive to ensure that all this remains under the competence of the German authorities, if possible. So if we can do this, then opportunities for external meddling will be limited. And we are in a good negotiating position on this matter". See: <http://en.kremlin.ru/events/president/news/50582>

⁷⁷ Energy Union Communication, op. cit., 4.

⁷⁸ Gazprom already provides over 40% of the natural gas consumed in Germany.

The Commission has also placed a heavy emphasis on the role of competition in developing a European single gas market.⁷⁹ It is again difficult to see how launching Nord Stream 2 will improve competition in the gas market. The project as explained above will increase Gazprom's market dominance in Germany and increase its presence in the rest of North-Western Europe. It will also increase Gazprom's market power in Central and Eastern Europe, particularly by increasing the capacity of the OPAL route with EUGAL to 86bcm. The project will also give Gazprom significantly more pipeline optionality and thereby more capacity to affect pricing across the European gas market. Perhaps most fundamentally of all in single market terms Nord Stream 2 is likely to divide the European gas market in two, with a well-supplied and liquid market in North-West Europe, and a less well-supplied and more heavily dependent gas market in Central and Eastern Europe.

The Energy Union Communication also emphasises the need to ensure access to secure sources of supply.⁸⁰ However, as explained above, Nord Stream 2 endangers the 'throughput security' of the CEE states. And as also explained above the alternative of reverse flows via Nord Stream 2 could be undermined by Gazprom limiting supply flows into the pipeline.⁸¹

It could be argued that, whatever express policies the Union has developed in respect of energy security, they have to give way in the face of the realities of the energy market. Domestic natural gas production in the European Union is falling,⁸² and Russia has the world's largest proven resources of natural gas.⁸³ Hence, the Union has to recognise its supply vulnerability and take steps to ensure access to sufficient supplies of natural gas into the Union. There are two major difficulties with this argument.

First, Nord Stream 2 involves building new pipelines into which natural gas flows will be diverted from the Ukrainian pipeline network into NS2. As a consequence, there is no obvious increase in new gas supplies from the Russian Federation, merely the diversion of gas supplies that would otherwise transit the Ukrainian and Yamal pipeline networks.⁸⁴

Second, whilst it is true that domestic natural gas production in the EU is falling, and Russia is the holder of the largest proven natural gas reserves, this argument for Russian dependence overlooks the fact that the world is awash in natural gas. As the US Energy Information Administration (EIA) makes clear in its *International Energy Outlook 2016* there is enormous

⁷⁹ *European Energy Security Strategy*, op. cit.

⁸⁰ *Energy Union Communication*, op. cit., 4.

⁸¹ As explained in more detail above the difficulty with reverse flows via Germany and the Nord Stream 2 pipeline network is that supply can be cut from the Russian side, reducing the gas flow so that there is only sufficient for Western customers and not for CEE states. This is not a theoretical possibility, as this is exactly what happened to Ukraine in 2014, when in reaction to reverse flows to Ukraine from some of the CEE states, Gazprom sought to reduce the amount of gas that those states received in order to limit the scale of reverse flows.

⁸² The EU's two largest gas producers are the Netherlands and the UK. Both are seeing significant and sustained falls in domestic production (see "Five Questions for Europe's Gloomy Natural Gas Market in 2016", Bloomberg, 31 December 2015).

⁸³ Russian proven natural gas reserves stand at 48 trillion cubic metres (<https://www.gecf.org/countries/russia>).

⁸⁴ There is the argument that Ukraine is an unreliable transit carrier, but as explained above that argument does not stand up to any close examination.

amounts of natural gas coming on stream.⁸⁵ The shale gas revolution has only just started going global. Currently only the US, Canada, China and Argentina⁸⁶ produce shale gas. This is likely to significantly expand in the 2020s with both Mexico and Algeria bringing on new production.⁸⁷ In addition, the United States is ramping up its own liquefaction capacity on its eastern seaboard.⁸⁸ As Henderson and Mitrova have pointed out, with low Henry Hub prices a short-run marginal cost, LNG can be landed in Europe at prices that can compete head on with Gazprom, unless the Russian producer is willing to sustain a heavy profit sacrifice.⁸⁹

There is a danger here that Europe may lock itself into a dependence on Gazprom based on fears of falling domestic natural gas production, when those fears are wholly unfounded.

There is a broader policy conflict issue that cannot be avoided being discussed in respect of Nord Stream 2. In March 2014, the Russian Federation annexed Crimea, the first European annexation since World War II. In addition, eastern Ukraine was invaded and occupied by forces that were either supported or financed by the Russian state or were actually Russian military forces.⁹⁰

The EU and the US condemned this attack on the integrity of a European state and the breach of the principle of territorial integrity set out in Article 2(4) of the UN Charter⁹¹ and Articles III and IV of the Helsinki Accords. As a result sanctions have been imposed by the EU and the US, and financial and reform assistance extended to Ukraine.

In this context it is difficult to see how EU member states or the EU itself can support further Russian-EU co-operation through Nord Stream 2. Particularly when supporting Nord Stream 2 runs counter to EU and US policy in opposing the attacks on the physical integrity of the Ukrainian state. The effect of Nord Stream 2 by diverting transit flows is to strip Ukraine of approximately \$2 billion in transit revenues at a time when the state has been weakened by the invasion and occupation and the EU and the US are providing financial support. In

⁸⁵ *International Energy Outlook 2016*, op. cit., 37 et seq.

⁸⁶ Gomes & Brandt, "Unconventional Gas in Argentina: Will it become a gamechanger?" (2016) OIES, Oxford.

⁸⁷ *Shale Gas Production Drives World Natural Gas Production Growth*, EIA, Washington, D.C., 15 August 2016.

⁸⁸ *Growth in Domestic Natural Gas Production Leads to Development of LNG Export Terminals*, EIA, Washington, D.C., 4 March 2016.

⁸⁹ Henderson & Mitrova, *The Political and Commercial Dynamics of Russia's Gas Export Strategy*, (2015) OIES, 44-45. There will also be a knock-on effect on the shale gas industry of technological development in respect of shale oil production which has seen dramatic falls in the cost of production through a mixture of redesign of production operations and technological development. Greater capacity to produce at much lower cost levels in shale oil and shale gas plays will feed through in the natural gas market into lower Henry Hub prices. See "Cost Reductions Help US Shale Oil Industry Pass First Real Test", *Financial Times*, 28 August 2016.

⁹⁰ Wilson et al., "Hiding in Plain Sight: Putin's War in Ukraine" (2015), Atlantic Council, Washington, D.C., and Nemtsov et al., "Putin.War-Based on Materials from Boris Nemtsov", in Yashin & Shorina (eds), *Independent Export Report*, Moscow (2015).

⁹¹ For a discussion of the application of public international law, and the case law of the ECHR to the territories invaded, occupied and annexed by the Russian Federation, see A. Riley, "Ukraine v. Russia and the Kleptocrats" (2016) Atlantic Council, Washington, D.C.

addition, the effect of removing Ukraine as a transit state would be to isolate Ukraine from potential European allies, while making it more vulnerable to Russian aggression. In other words, NS2 undermines the EU and US objectives in supporting Ukraine when under direct military and economic threat from the Russian Federation.

This does raise an additional public international law, rather than EU law issue: The extent to which states are obligated under customary international law and the obligations that flow from Article 2(4) of the UN Charter to not recognise or support invasion, occupation or annexation by an aggressor state.⁹² Given the discussion above the argument can be made that states should not support the development of NS2 or otherwise they are in breach of their obligations under public international law. For the states through whose EEZs NS2 would pass, they have an obligation to apply UNCLOS procedures in compliance with their broader public international law obligations.⁹³ For the Union, it would be required to apply EU law, and in particular exemptions and certifications in accordance with its public international law obligations.

A further concern with the Nord Stream 2 pipeline proposal is that it makes both Germany and a number of CEE states more dependent and more vulnerable to a state which has demonstrated its willingness to ignore the norms of international law. It is perplexing that given recent Russian aggression and the steps taken to contain Russia, and the damage that NS2 would inflict on Ukraine that the project has received any Western support at all.

11. Conclusion: Nord Stream 2 – A way forward for Russia-EU energy relations?

In conclusion this paper argues that Nord Stream 2 in both EU legal and policy terms is unviable. If despite the setback caused by the Polish competition authority determining that NS2 undermined competition on the Polish domestic market Gazprom continues to proceed with the project it is likely to face further regulatory challenges. It is also difficult to see how the European Commission can maintain its credibility as Guardian of the Treaties if after having failed to apply EU law to Nord Stream 1, it fails again to do so in respect of Nord Stream 2. This paper in this conclusion goes on to argue, however, that this pipeline conflict is unnecessary and that there is a positive way forward for both the EU and Russia to develop their energy relationship.

The legal unviability of Nord Stream 2 stems from the argument developed above: EU law applies at least in the German and Danish territorial sea and in Germany's inland waters through which Nord Stream 2 will pass. It is also highly probable it applies in the EEZs of Germany, Denmark, Sweden and Finland. It is also clear from the argument above that Nord Stream 2 will be deemed a transmission pipeline under the Gas Directive. As a consequence, the full weight of the obligations under the Gas Directive falls upon Nord Stream 2 within the EU's jurisdiction. This includes ownership unbundling, third party access and tariff regulation. Those obligations would be extremely difficult for NS2 to comply with. Gazprom

⁹² See in particular ICJ Advisory Opinion, *Israel-Palestine Wall*, 9 July 2004. Paras 155-159.

⁹³ It is noteworthy that Article 88 of UNCLOS limits its field of application "to peaceful purposes".

would face having to pay transit fees to a third party TSO. EU requirements as to third party access could be only complied with if the Russian Federation lifted Gazprom's export monopoly, and it would have to accept tariffs regulated by the NRAs.

Furthermore, not merely is an exemption under Article 36 improbable, it is also extremely unlikely that the Commission can grant certification to the TSO under Article 11. There is a clear negative impact on the supply security of several CEE member states if Nord Stream 2 comes into operation. CEE states lose 'throughput security', isolating them from the rest of the single market and making them more vulnerable to Russian pressure. In addition, the further obligations placed on the EU and the member states by the Energy Community Treaty and the consequent duty of loyalty and co-operation make it even more difficult to see how Articles 36 and 11 can be positively applied to NS2. If the Commission nevertheless agrees to grant Article 11 certification, it would be likely to be challenged judicially, with the issues ultimately ending up before the EU courts in Luxembourg.

The proposed feeder pipeline for Nord Stream 2, EUGAL, is in a similar position to the main pipeline as a result of the fact that almost all the gas from NS2 will feed EUGAL. It could in fact be argued that EUGAL is in a worse regulatory position than Nord Stream 2. It follows the route of the OPAL pipeline. Hence its 51bcm capacity, on top of OPAL's 35bcm capacity will reinforce OPAL's impact in CEE markets. Again EUGAL is likely to face challenges in respect of compliance with the liberalisation and certification requirements of the Gas Directive, notably Articles 36 and 11.

Underpinning these legal arguments are arguments from precedent and policy. Both Yamal and South Stream have been subject to the full application of EU energy law, and the Gas Directive in particular. It is difficult to see how Nord Stream 2 (and for that matter Nord Stream 1) can sustain having EU law applied to it as well.

In policy terms, Nord Stream 2 cuts across the principles of consultation and co-operation enshrined within the Energy Union. It also undermines the Energy Union's commitment to diversification of its routes and suppliers. Nord Stream 2 in fact *concentrates* routes and increases dependence on one supplier. By undermining incentives to develop new interconnectors and terminals, Nord Stream 2 will also make it more difficult for the EU to meet one of the main Energy Union objectives of completing the single market in gas.

In broader policy terms Nord Stream 2 also undermines EU and US policy on Ukraine. If NS2 comes on-stream, it will strip Ukraine of most of its remaining \$2 billion in transit fees, and render the country more vulnerable to influence by the Russian Federation. This is at a time when the EU and the US are seeking to assist Ukraine to overcome the impact of annexation, occupation and economic collapse. And where the West is seeking to support the Ukrainian government in ensuring its economic independence, strengthen its financial capacity and promote reform in its energy markets.

The Nord Stream 2 project also raises questions as to why EU law was not applied to Nord Stream 1. There is a compelling argument, that in promoting Nord Stream 2, Gazprom has both launched a project that cannot be delivered under modern EU energy liberalisation law, whilst at the same time putting a spotlight on Nord Stream 1, raising legitimate concerns as to why it has not also been subject to EU law, particularly given the application of EU law to the Yamal and South Stream pipelines. As the Commission's responses to several Parliamentary

Questions indicate that it was fully aware of the development of the NS1 pipeline and undertook an assessment of the project, it is difficult to come any other conclusion than that political pressure was applied to ensure NS1 was not subject to the EU's energy regulatory regime. It is not inconceivable that steps will be taken by concerned member states or energy companies to file a complaint with the Commission to seek an enquiry into the investigation of the status of NS1, and ensure that, NS1 is subject to EU law in the same way that EU law was applied to the Yamal and South Stream pipelines.

There is also a parallel concern in respect of the NEL and OPAL pipelines. As explained above NEL was treated by the German NRA as constituting an extension of the existing pipeline network. This meant it could avoid being subject to the ownership unbundling rules contained in the Gas Directive, and mandatory for all new infrastructure. It is difficult to see how the German NRA can sustain an argument for such a decision under the terms of the Gas Directive, its secondary legislation and the interpretative guidance. The Commission was critical in its opinion but did not institute infringement proceedings. Equally in respect of both OPAL and NEL there are questions as to why no Article 11 certification procedure was undertaken by the NRA or why the Commission, unlike Yamal, did not require the NRA to undertake such a process. However, as with NS1, it is possible that some CEE states or energy companies may well now file a complaint with the Commission over this further lack of application of Union law.

By launching the Nord Stream 2 project Gazprom may have unwittingly disturbed sleeping regulatory dogs, which now will bear down on Nord Stream 1 and its feeder pipelines, while blocking Nord Stream 2.

The whole diversification strategy adopted by Gazprom – initially starting with Yamal and Bluestream, then Nord Stream 1, then putatively with South Stream and Turkishstream, now Nord Stream 2 and perhaps now Turkishstream again – has become over time increasingly anachronistic and misguided. Trying to create endless diversification pipelines is anachronistic given the development of EU energy law and an increasingly integrated European gas market. Gazprom as a gas supplier cannot expect to control pipeline routes and isolate markets as it did a decade ago in a now increasingly liberalised European market. Equally, Ukraine itself is now fully subject to the energy *acquis* of the European Union, via the Energy Community and has undertaken significant domestic energy reforms. Whatever concerns Russia had a decade ago in respect of Ukrainian transit do not apply today. There is no need for a diversification strategy. Both Gazprom and the Russian Federation appear to also be unaware of the damage that playing pipeline politics has on their customers in the CEE and Baltic States. The launch of the Nord Stream 2 project will have set off another round of alarm in CEE and Baltic State national capitals with energy ministries seeking to develop more ways of reducing their use of Russian natural gas.

It is also misguided because there is an alternative, more profitable and more positive strategy for the Russian Federation and the EU. The development of an open, liberalised and interconnected European gas market is a huge opportunity for Gazprom. It is the closest largest producer of natural gas to the European market. It should be able to profit most from its proximity to a huge continental wide gas market as it becomes ever more interconnected. It is true that domestic demand has been falling, which offsets to some extent the impact of falling domestic production levels. It is also true that the EU is seeking to shift ever more of its

energy production base to renewables. However, for a long time to come the EU will need baseload and natural gas, with its low CO₂ emissions, and capacity to ramp up quickly in CCGT power stations, is ideally placed to provide that baseload.⁹⁴

Rather than proposing Nord Stream 2 or Turkishstream, Gazprom should instead seek a deal whereby the EU promotes natural gas over coal. This would involve reforming the emissions trading scheme, so that the ETS is better able to effectively discourage coal use and promote natural gas. In parallel, the Union and the member states would seek to promote coal-bed methane extraction over coal within the EU, removing many of the objections to greater use of gas from coal-producing member states. The Union would also seek to promote greater use of natural gas vehicles further expanding the potential size of the European natural gas market.

Gazprom in turn would adopt a high-volume low pricing strategy that would aim to maximise the use of the cheapest pipeline networks available to push gas through into the European market. In this scenario, Europeans no longer worry about Russian diversification pipeline strategies, because as the market is so interconnected, any concerns over reliance on Russian gas supplies dissipate. Ironically, the very single market in gas, and the EU energy liberalisation regime to which Gazprom has so objected, makes it easier for Europeans to take more natural gas from Gazprom.

Even if, as is likely, European domestic natural gas production continues to fall, Europeans, in a world awash with natural gas will gain tremendous advantage from a single market. In a deeply interconnected liberalised natural gas market, Gazprom would sell much more gas and have a major role in the market. At the same time, Gazprom would face competition particularly from LNG producers who would seek to take market share off Gazprom and create significant price competition. Whilst Gazprom would retain a pricing advantage over LNG it would face some competitive pressure in its battle with LNG producers, thereby giving Europeans both pricing and energy security comfort.

In other words the argument here is that Germany and other EU member states that go along with the Russian diversification strategy should instead put greater faith and support in the single market they have done so much to create. A fully liquid, interconnected, liberalised European gas market is the most effective way to ensure EU supply security. It also is a huge opportunity for Gazprom if it is willing to fully recognise that opportunity.

The EU and its member states should focus EU-Russian energy relations on building a consensus with Russia around the value and opportunities available in a deep, liquid and interconnected European gas market. This focus should however be accompanied by an edge that ultimately, if Russia does not wish to take up the opportunities on offer, then Europe will move away from Russian gas in particular, and natural gas in general as it seeks a more sustainable energy future.

⁹⁴ The potential impact of natural gas in underpinning an effective climate change strategy is underlined by the analysis undertaken by McKinsey that if the load factor of the average European CCGT power station was raised from 45% to 75%, the EU could reduce CO₂ emissions by at least 250 million tonnes per year. To achieve the same CO₂ cuts with renewables would require a capital expenditure of between €80-€120 billion (see *Making the Green Journey Work*, 2011).



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